

U.S. Structured Finance Newsletter

Volume 6, Issue 24, June 29, 2009



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Financial Regulatory Reform Could Pose a Threat to Securitization

On June 17, 2009, the Obama administration released a proposal for reform of the financial system.¹ Its key aims are to promote robust supervision and regulation of financial firms, establish comprehensive regulation of financial markets, protect consumers and investors from financial abuse, provide the government with tools to manage financial crises, and raise international regulatory standards. Of the five main sections in the proposal the one entitled, "Establish Comprehensive Regulation of Financial Markets" contains the recommendations for securitization. Listed below are several of the section's highlights.

Require "loan originators or sponsors" to retain 5% of the credit risk of securitized exposure:

Currently, the language around the 5% retention requirement is unclear with regards to defining credit risk. Without knowing how credit risk is defined, it is difficult to predict how much of an impact this requirement could have on subordination levels. Nevertheless, it has the potential to dissuade securitization, since the ability to sell risk and achieve the accompanying capital benefits would be greatly limited.

Align compensation of securitization participants with the long-term performance of underlying loans, including the elimination of gain-on-sale accounting:

The proposal encourages the Financial Accounting Standards Board (FASB) to eliminate gain-on-sale accounting, and require many securitizations to be consolidated on-balance-sheet. This will ensure that the performance of the securitized receivables is reflected on the consolidated financial statements. If adopted, the removal of gain-on-sale accounting may prove to be a deterrent to securitization.

Require increased transparency and standardization of securitization markets and give the SEC clear authority to require robust reporting by issuers of ABS:

Ongoing efforts by the Securities and Exchange Commission (SEC), together with the industry, to achieve greater transparency in the ABS industry were strengthened by the proposal. It asks that issuers of ABS be required to provide loan-level data (broken down by loan broker or originator) as well as disclose the "nature and extent of broker, originator, and sponsor compensation and risk retention for each securitization."

Strengthen the integrity of the ratings process by increasing the regulation of the rating agencies:

The recommendation includes plans for higher levels of transparency within rating agencies. It asks that they be required to give more disclosure regarding how their ratings should be used, as well as what the ratings are not designed to address. The proposal goes on to stipulate that rating agencies should differentiate the credit ratings they assign to structured credit products from those they assign to unstructured debt.

Reduce the use of credit ratings by regulators:

The proposal requires regulators to do more independent credit work rather than rely solely on credit ratings.

The rationale underlying much of the securitization-related aspects of the reform proposal is intended to increase transparency and better align incentives with the risks assumed. However, given the magnitude of this wide-sweeping proposal, many expect that it could take several months of negotiating before a final policy is put into place. As a result, DBRS will continue to monitor the industry for its reaction to the proposed recommendations as well as any impact the final reform will have on the secondary market.

For questions or comments please contact Maxim Berger at mberger@dbrs.com or Kathleen Tillwitz at ktillwitz@dbrs.com.

1. The full proposal, Financial Regulatory Reform: A New Foundation, can be found at <http://www.financialstability.gov/roadtostability/regulatoryreform.html>